Financial Services Management

Climate-Risk Management

Cite

FRB, Notice and Request for Comment, Principles for Climate-Related Financial Risk Management

Recommended Distribution

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Website

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Impact Assessment

- Although proposed as standalone climate-risk principles, the Board appears open to and perhaps even partial to having banks incorporate these risks into broader management and governance frameworks rather than a freestanding set of policies and procedures addressing only climate risk.
- Although scenario analyses would be required, banks would have considerable discretion as to what scenarios assess and clearly need not base capital planning on analytical outcomes.
- As with the OCC, climate-risk management is to focus not only on financial risks to the institutions, but also impact on stakeholders such as low/mod-income communities. It remains to be seen if this is a new regulatory paradigm for other risk considerations.

Overview

Following the pattern set in 2021 by the OCC,[1] the FRB has now proposed climate risk-management standards as high-level principles to guide banking organizations with assets over $100 billion. As with the OCC's proposal and the very similar one that followed it from the FDIC, the FRB would give large banking organizations considerable discretion to manage climate financial risk as long as the organization expressly and transparently does so. The Board is more explicit about the flexibility banks would have to decide if climate risk warrants a separate set of policies and procedures or if it can be incorporated into the broader risk-management construct. However, regardless of an institution's choice, the board of directors and senior management would need to ensure that climate risk is identified, measured, managed, and mitigated to the greatest extent possible consistent with the company's business model and available climate-risk data. Scenario analyses would also be required, although banks would have considerable flexibility conducting them.

1 See **GREEN12**, *Financial Services Management*, January 4, 2022.

Impact

Although the Board notes that banking organizations of any size may have material climate-risk financial exposures, the request focuses on the largest institutions because of their importance to the economy and to financial stability. The principles are thus based on matters that would affect individual companies and the system as a whole, with the goal of this initial effort to develop a consistent framework for risk identification, measurement, monitoring, and control that is then incorporated into a bank's overall risk-management approach. The focus is exclusively on financial risk, but this is likely not to deter Republican critics of any banking-agency standards that target climate risk for special attention above and beyond that given to all other forms of risk even though the Board here indicates that its goal is to ensure climate risk fits into the broader framework, not to mandate a new, climate-specific one.

Banks have also argued that differentiating climate risk is challenging at this early stage of measurement methodology, but the OCC, FDIC, and now the Fed have at least preliminarily concluded that risks are structurally different and of such magnitude as to warrant separate attention. However, it also stipulates that these principles are meant only to "support" bank thinking about the best way to incorporate climate-risk into ongoing risk management. It is thus unclear if Fed-supervised banking organizations will feel the need to institute climate-specific standards or only demonstrate to examiners how this risk is factored into all the others in the firm's comprehensive risk-management and governance protocols.

Another significant concern of critics of climate-risk standards even when these are high-level, non-binding principles is that they will create a strong impression that banking agencies seek an end to bank exposures to fossil-fuel companies and others seen to be "brown." The Board is at pains to implicitly deny this in its draft, emphasizing that banks should serve their communities as they make risk-based decisions about how best to do so. Even so, legislation is likely next year in the House to expressly bar anything from any federal agency that supports restrictions on banking for any legal business, but any such measures along with efforts to block final action on these risk-management principles will not advance in the Senate and would in any case be vetoed by the President. That said, regulators and banks will come under heavy pressure in the next Congress at hearings to eschew any action that constrains support for any legal business, including those deemed polluters or carbon-emitters.

One of the most interesting aspects of the OCC proposal was a provision stipulating that boards of directors and senior management are to consider climate financial risks not only in terms of their institution, but also of stakeholders that include low-and-moderate income communities. This reflects a broader Biden Administration focus on climate risk's impact on vulnerable households who are, for example, more likely to live in flood-prone areas.[2] Community climate-risk considerations would also come under the new CRA rules,[3] but the mention here suggests that – at least in some high-profile areas – the banking agencies have adopted an approach to "stakeholder

[2] See **GREEN8**, *Financial Services Management*, May 25, 2021.

[3] See **CRA32**, *Financial Services Management*, May 17, 2022.

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rulemaking" beyond direct consideration of financial risk. This may be considered "woke" by GOP critics and factor into the criticism of the proposals noted above.

These principles also reflect the Fed's recent decision to mandate climate-scenario analyses for the nation's very largest banks. Few public details are available on these tests, but it is most unlikely that they will mandate capital planning akin to the specific requirements in broader stress-testing standards. The proposed principles are still less prescriptive, allowing banks to run scenarios for qualitative issues such as their strategies as well as for more quantitative insights into physical and transition risks. Although the principles say only that analysis results would need to go to the board and other relevant internal staff, it seems likely that examiners would want not only to know if these scenario analyses were completed and appropriately discussed, but also what results show and how the bank is responding to them.

What's Next

The Board proposed these principles on December 2; comment is due sixty days after *Federal Register* publication. As noted, the OCC has yet to finalize its principles; the FDIC in March of this year issued a very similar proposal which is also not yet set in final form. We expect all of the agencies to confer upon review of comments to the Fed and finalize inter-agency standards in the first quarter of 2023.

Analysis

A. Principals

These would be:

- **Governance:** The board of directors would need to understand climate risk's financial impact on its institution across various scenarios and planning horizons, holding management accountable for remaining within risk parameters. The board is also to consider the extent to which incorporating climate risk into broader risk-management activities requires additional resources, new compensation policies, and strategy. The principles also detail senior-management responsibilities, incorporating climate risk into all relevant plans, policies, and procedures. The board and senior management would also need to consider climate risk when setting strategy, taking into consideration implications not only for the bank, but also stakeholders such as low-and-moderate income communities. Reflecting SEC concerns, the board and senior management are also to ensure that public statements regarding activities in this area are accurate.

- **Risk Management:** The principles would include a detailed discussion about how best to identify, measure, and manage climate risk. These processes would need to cover material financial risks under plausible scenarios.

- **Scenario Analysis:** Management is told to develop and implement scenario analyses that include clear objectives germane to the company's size, complexity, and related factors. The FRB would give banks considerable flexibility setting these analytical objectives, allowing them for example to be limited to understanding how climate risk affects a bank's strategy. Even so, these analyses would need to be subject to oversight (see above), validation, and quality control, with results regularly communicated to the board and other relevant persons in the organization.

- **Management and Risk Areas:** Here, the Board details how climate risks are to be factored into broader risk-management activities, noting the categories (e.g., credit) into which it may fit.

B. Request for Comment

This is specifically sought on:

- climate-risk management challenges;
- current data availability; and
- challenges incorporating these principles into broader risk-management requirements.